Supreme Court, U.S.
FILED
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79-1402

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

IVEN S. YOUNG, ET AL.,

Petitioners,

v.

DISTINCTIVE DEVICES, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF NEW YORK

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DISTINCTIVE DEVICES, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF NEW YORK

Galpeer, Altus, Karp & Beckerman, on behalf of Iven S. Young, et al. (the individual appellants in the Court of Appeals of the State of New York), petition for a writ of certiorari to review the order of the Court of Appeals of the State of New York, which denied petitioners' motion for leave to appeal to that court from an order of the Appellate Division affirming the Supreme Court's order denying the petitioners' motion for summary judgment, granting summary judgment to the respondent and dismissing the action.

Opinions Below

The opinion of the Supreme Court of the State of New York, County of New York, is appended hereto in Appendix A, *infra,* pages 1a-3a, as is the order and judgment entered on said opinion (Appendix A, *infra,* pp. 4a-5a and 6a-7a, respectively).

The Appellate Division did not render any opinions. It unanimously affirmed the Supreme Court order and judgment and unanimously denied petitioners' motion for leave to appeal to the New York State Court of Appeals. (Appendix B, *infra,* pp. 8a-9a and 10a-11a, respectively.) The Court of Appeals also did not render an opinion, but entered an order denying petitioners' motion for leave to appeal to that Court (Appendix C, *infra,* p. 12a).

Jurisdiction

The order of the Court of Appeals (Appendix C, *infra,* p. 12a) was entered on December 13, 1979. The jurisdiction of the Supreme Court of the United States is invoked under 28 U.S.C. § 1257(3).

Question Presented

Whether "mandatory" provisions in a trust indenture for the payment of interest when due, required by Section 316(b) of the Federal Trust Indenture Act of 1939 (the "Act") and made controlling over conflicting "permissive" provisions by Section 318(a) of the Act, can, nevertheless, be rendered subordinate to such permissive provisions by interpretation of the Courts of the State of New York.

Statute Involved

The Trust Indenture Act of 1939, 15 U.S.C.A. §§ 77 a a a et seq., is the federal statute upon which this action is based. The sections relevant to this case are set forth below:

(Prohibition of Impairment of Bondholder's Right to Payment)

Sec. 316(b) The indenture to be qualified shall provide that, notwithstanding any other provision thereof, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a), and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien. C.C.H. Vol. 4, *Federal Securities Law Reporter,* p. 32, 362, Par. 42, 536.

(Prevalence of Required ["mandatory"] Provisions over Those in Conflict)

Sec. 318. (a) The indenture to be qualified shall provide that if any provision thereof limits, qualifies, or conflicts with another provision which is required to be included in such indenture by any of sections 310 to 317, inclusive, such required provision shall control. C.C.H. Vol. 4, *Federal Securities Law Reporter,* p. 32, 381, Par. 42, 554.

(Additional ["permissive"] Provisions Not In Conflict with Act)

Sec. 318. (b) The indenture to be qualified may contain, in addition to provisions specifically authorized under this title to be included therein, any other pro-

visions the inclusion of which is not in contravention of any provision of this title. C.C.H. Vol. 4, *Federal Securities Law Reporter*, p. 32, 381, Par. 42, 556.

Statement

This is a suit brought primarily to recover interest due on an aggregate principal amount of $12,000 of 5½% Convertible Subordinated Debentures due December 6, 1983 ("Debentures"). These Debentures were purchased by the petitioners from the respondent in December 1968 (1-8).* The Debentures were registered for sale with the Securities and Exchange Commission, were negotiable in form and were publicly traded. They provide for the payment of interest semi-annually on June 1 and December 1 of each year until maturity (23). Respondent failed to make the required interest payments due on December 1, 1977 and June 1, 1978 and thus this action was commenced. In fact, since this action was commenced, respondent has failed to make the interest payments due on December 1, 1978; June 1, 1979; and December 1, 1979 and has announced its intention to continue to default at least through 1980 (139).

The Debentures themselves contain an absolute and unconditional undertaking to pay principal and interest on their respective maturity dates, regardless of any other provision in the Debentures or in the Trust Indenture dated December 6, 1968 ("Indenture") (29-125) under which the Debentures were issued. The undertaking reads:

> "No reference herein to the Indenture and no provision of this Debenture or of the Indenture shall alter or impair the obligation of the Company, which is absolute and unconditional, to pay the principal of (and premium, if any) and interest on this Debenture at the times, place and rate, and in the coin or currency, herein prescribed." (24, sixth paragraph, right column).

This is repeated in the Indenture at Section 203 (54, first full paragraph).

The respondent was obligated by federal law to qualify the Indenture pursuant to the Trust Indenture Act of 1939, 15 U.S.C.A. §§ 77aaa et seq. (the "Act"), which it did. Section 316(b) of the Act provides that:

> "The Indenture to be qualified *shall* provide that, notwithstanding any other provision thereof, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder . . . ." C.C.H. Vol. 4, *Federal Securities Law Reporter*, p. 32, 362, Par. 42, 536 (emphasis added).

This mandatory provision required to be included in the Indenture is within the purview of Section 318(a) of the Act which states:

> "The Indenture to be qualified *shall* provide that if any provision thereof limits, qualifies, or conflicts with another provision which is required to be included in such indenture by any of Sections 77jjj to 77qqq of this title, inclusive, *such required provision shall control.*" C.C.H. Vol. 4, *Federal Securities Law Reporter*, p. 32, 381, Par. 42, 560 (emphasis added).

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* Numbers in parenthesis refer to the Record on Appeal in the Supreme Court of the State of New York, Appellate Division, First Department.

As stated above, the respondent's Indenture qualified under the Act and contained all requisite provisions.

The respondent admits that the required interest payments have not been made, but justifies this default by claiming that since it is in default in its "Senior Debt" (defined in the Indenture to include virtually every obligation, past, present or future, of the respondent (43-44), Section 1405 of the Indenture, a permissive provision found on page 122 of the Record, allows respondent to renege on the payment of interest or principal to its debenture holders (26-27). Respondent further contends that the petitioners have no individual remedy for this admitted default, but can only act through the Indenture Trustee because of Sections 502 (66) and 507 (69-70) of the Indenture (other permissive provisions) (28). In effect, respondent claims that these permissive provisions of its Indenture take precedence over Section 316 (b), the mandatory provision required by the Federal Trust Indenture Act of 1939.

Petitioners contend that by virture of Section 318(a) of the Act, the aforesaid permissive provisions (Sections 1405, 502 and 507) of the Indenture are subservient to Section 316(b), the mandatory provision, which is clear in its mandate that the debenture holder's right to "receive payment of . . . interest . . . or to institute suit for the enforcement of any such payment . . . shall not be impaired or affected . . ." (128-133, 146-147). Pursuant to the terms of Section 318(a), Section 316(b) must control.

Petitioners also contend that the permissive provisions of the Indenture apply only in the event of an insolvency proceeding under judicial guidance. The respondent is not, and has not been so involved (129-130).

Petitioners' contentions were raised in the Supreme Court of the State of New York, the court of first instance,

in a Reply Affidavit submitted on a motion by petitioners for summary judgment in lieu of complaint (126-127). Specifically, petitioners raised the federal question on pages 132 and 133 of the Record as follows:

> "(e) The Trust Indenture Act of 1939 *prohibits* any provision in the Indenture which impairs the right to sue for non-payment of interest.

20. To protect the absolute and unconditional right of debenture holders to be paid interest when due, Section 316(b) of the Trust Indenture Act of 1939, to which the Indenture is subject prohibits any provision impairing that right. This section was passed to prevent exactly what the defendant is trying to do.

> 'Evasion of judicial scrutiny of the fairness of debt-readjustment plans is prevented by this prohibition.' *House Committee Report* No. 1016, 76th Cong. 1st Sess., p. 56.

21. Furthermore, this Section prohibits any provision in an Indenture which would impair the Indenture holders' right to bring suit directly against the debtor. Section 316(b) reads in part:

> '. . . *(N)otwithstanding any other provisions thereof,* the right of any holder of an Indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, *or to institute suit for the enforcement of any such payment* on or after such respective dates, shall not be impaired or affected without consent of such holder, . . .' (Emphasis added.)

22. The few exceptions to this basic rule are not applicable in the instant case. It is therefore crystal clear that defendant's Indenture does not, *and cannot,* impair the plaintiffs' rights to sue."

Petitioners again raised the federal question in a Second Supplemental Reply Affidavit submitted on the same motion (146-147) as follows:

> "2. Mr. Folkenflik's apology notwithstanding, even the existence of a default in 'senior' debt does not excuse nonpayment. The debenture is clear and unequivocal on its face.
>
> '. . . *no provision of this Debenture or of the Indenture* shall alter or impair the obligation of the Company, which is *absolute and unconditional, to pay* . . .'
>
> 3. This was required by §316(b) of the Trust Indenture Act ("Act") for the Indenture to qualify, and by §3-104(1)(b) of the Uniform Commercial Code for the debenture to be negotiable.
>
> 4. Without negotiability the Securities and Exchange Commission would not permit a public sale of the debentures. Without a public market, the plaintiffs would not have purchased them from the defendant.
>
> 5. To claim that Section 1405 of the Indenture supercedes this prime covenant of the debenture is to assert a failure of consideration. If that be the case, then plaintiffs are clearly entitled to the return of the consideration they paid to the defendant.
>
> 6. However, the alleged 'prohibition' of Section 1405 is only a 'permissive' provision of the Indenture. It is expressly made subject to the 'mandatory' provisions of §316(b) of the Act. Therefor, by virtue of §318 of the Act and Section 107 of the Indenture itself, when there is any limitation, qualification or conflict between such provisions, *the mandatory provisions control.*"

The Supreme Court of the State of New York, County of New York, held that Section 1405 of the Indenture controlled the case and therefore granted judgment to the respondent dismissing petitioners' complaint against it (Appendix A, *infra,* pp. 1a-3a):

> "There are no issues of fact before the court but rather only one of law. It is for the court to decide the application of the provisions of the debenture and the indenture agreement.
>
> Contrary to the plaintiffs' contention, the court finds that section 1405 of the Indenture is applicable in the instant situation.
>
> Section 1405 provides as follows:
>
> 'Section 1405. Default on Senior Debt. If there shall have occurred a default in the payment of the principal of (or premium, if any) or interest on any Senior Debt, then, unless and until such default shall have been cured or waived, no payment shall be made by the Company with respect to the principal (including Sinking Fund Payments) of (or premium, if any) or interest on the Debentures, except that Debentures acquired prior to such default may be delivered in lieu of a Sinking Fund Payment in cash in accordance with Section 1201.'"

The decision failed to address itself to the overriding mandatory requirements of the Act raised by the petitioners. In fact, the applicable mandatory provisions of the federal Act were not even mentioned or cited, let alone discussed. The Act was totally ignored.

Petitioners again addressed the federal questions involved in their brief and reply brief filed on their appeal

to the Supreme Court of the State of New York, Appellate Division, First Department. The Appellate Division, without an opinion, unanimously affirmed the decision of the lower court (Appendix B, *infra,* pp. 8a-9a). Again, the mandatory requirements imposed by the federal law were totally ignored and thus, in effect, the Trust Indenture Act of 1939 held meaningless.

The federal questions were once again raised on petitioners' motion for leave to appeal to the Court of Appeals of the State of New York. That court unanimously denied said motion without opinion (Appendix C, *infra,* p. 12a). It too ignored the federal statute and by implication held it invalid.

REASONS FOR GRANTING THE WRIT

Preliminary Statement

This case presents important substantive questions concerning the interpretation of the Federal Trust Indenture Act of 1939 (the "Act") which have not previously been considered by this Court. In addition, the decisions of the New York State courts completely ignore the pertinent statutory provisions which are clear and unambiguous; conflict with the only case found that deals with this issue, the federal case entitled *Continental Bank & Trust Co.* v. *First Nat. Petroleum Tr.,* 67 F. Supp. 859 (District Court, D. Rhode Island 1946); fly in the face of the practices of the Securities and Exchange Commission; and ignore completely the understanding of the securities industry in general.

Statutory Law

Payment of interest and the right to sue to enforce that payment is required by Section 316(b) of the Act:

> "The Indenture to be qualified *shall provide* that, notwithstanding any other provision thereof, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder . . . ." C.C.H. Vol. 4, *Federal Securities Law Reporter,* p. 32, 362, Par. 42, 536 (Emphasis added).

This section was passed to prevent exactly what the respondent is attempting to do:

> "Evasion of judicial scrutiny of debt-readjustment plans is prevented by this prohibition." *House Committee Report* No. 1016, 76th Cong. 1st Sess., p. 56.

Section 316(b) of the Act makes this a mandatory provision which must be included in a trust indenture. In case of any conflict between a mandatory provision and other provisions contained in the indenture, Section 318(a) of the Act provides that the mandatory provision controls:

> "The Indenture to be qualified *shall provide* that if any provision thereof limits, qualifies, or conflicts with another provision which is required to be included in such indenture by any of Sections 77jjj to 77qqq of this title, inclusive, *such required provision shall* control." C.C.H. Vol. 4, *Federal Securities Law Reporter,* p. 32, 381, Par. 42, 560 (emphasis added).

The Indenture in the case at bar, in Section 107 thereof, recognizes this mandate. The pertinent provision reads as follows:

> "If any provision hereof limits, qualifies or conflicts with another provision hereof which is required to be included in this Indenture by any of the provisions of TIA (Trust Indenture Act), such required provision shall control." (48).

The statute itself is unambiguous and the Indenture complies with the statute. The right of debenture holders to receive interest and principal payments is absolute and unconditional, as is their right to sue if such payments are not received. Trust Indenture Act, Section 316(b), C.C.H. Vol. 4, *Federal Securities Law Reporter,* p. 32, 263, Par. 42, 536. A provision which in any way limits, qualifies or conflicts with these rights, must be subservient. Trust Indenture Act, Section 318(a), C.C.H., Vol. 4, *Federal Securities Law Reporter,* p. 32, 381, Par. 42, 560. Nevertheless, the New York Courts held that Section 1405 of the Indenture, a permissive provision allowed by Section 318(b) of the Act controlled. They did not even discuss the distinction made by Section 318(a) of the Act between mandatory and permissive provisions of an Indenture. The federal statute was completely ignored, and was thereby stripped of its meaning and rendered ineffectual.

A case presenting an important and novel federal question such as this, affecting the efficacy of the Trust Indenture Act of 1939, is one in which the granting of certiorari is proper. Cf. *Wilko* v. *Swan,* 74 S.Ct. 182, 346 U.S. 427.

It should not be left for a state court to emasculate this federal statute's meaning.

Case Law

The only case found dealing with this precise question of mandatory versus permissive provisions is the federal case of *Continental Bank & Trust Co.* v. *First Nat. Petroleum, Tr.,* 67 F. Supp. 859 (District Court, D. Rhode Island 1946). In that case, the Court faced a problem identical to that posed by the case at bar. The decision of the federal court, however, is diametrically opposed to that rendered by the New York courts in the instant case. The existence of this conflict between a State Court and Federal Court decision makes this case appropriate for certiorari. See e.g., *Missouri Pac. R. Co.* v. *Elmore and Stahl,* 84 S.Ct. 1142, 377 U.S. 134, reh. denied 84 S.Ct. 1880, 377 U.S. 984.

In *Continental,* the Indenture, as it must, included the provisions required by Section 316(b) of the Act regarding payment of principal and interest on debentures (as does the Indenture herein). Interest payments were overdue and certain debenture holders sued to recover those payments (as in the instant case). The debtor as well as the holders of over 50% of the bonds, argued that the interest could be withheld under the terms of an Indenture. This is the very argument presented by the respondent herein, i.e. that Section 1405 of the Indenture allows interest to be withheld despite the requirements and mandates of the federal Trust Indenture Act of 1939.

The Court in *Continental* summarily dismissed the argument of the debtor, holding that such action:

> ". . . is directly contrary to the provisions of the Act expressly prohibiting impairment of the right of a

debenture holder to receive payment of interest. . . ." *Ibid.* p. 871

The Court also rejected the argument that it should not consider the provisions of the Act but rely only on the trust indenture itself to determine the parties' intentions.

> "I find no merit in this argument because the Indenture to be qualified must comply with Sec. 316. An interpretation of the Indenture qualified under the Act necessarily involves an interpretation of the Act . . .
>
> The right of the Indenture security holder, under the facts here, to his interest when due is absolute." *Ibid.* p. 871-82.

Despite being rejected by the *Continental* Court, this very argument was upheld in the New York courts in the case at bar.

Thus, the Court in *Continental* recognized the importance of the mandatory/permissive distinction and upheld the priority of mandatory provisions over permissive provisions based on Sections 316(b) and 318(a) of the Act; the identical sections on which the petitioners herein rely and which were ignored by the New York courts.

The rationale for this decision is stated by Professor Louis Loss, a noted securities law expert, as follows:

> ". . . to the extent that the act requires a particular provision to be included in the indenture, the entire theory of the statute would be destroyed if such a provision could be nullified by a conflicting provision of the indenture." *Securities Regulations Vol. II,* p. 749.

Securities and Exchange Commission Practice

The respondent in the courts below made much of the fact that the Indenture was reviewed by the Securities and Exchange Commission. In reality, this argument supports the view of the petitioners.

When reviewing indentures submitted for qualification under the Act, staff members of the Securities and Exchange Commission limit their review only to those sections which are mandated by the Act, e.g., 316(b) and 318(a). This review is facilitated by a "Tie" sheet included with the Indenture when filed which lists the provisions required to be included and the section of the Indenture where that particular provision may be found. The Tie sheet in the Indenture at bar is found at page 30 of the Record. It includes the mandatory Sections 316(b) and 318(a). The Commission's staff does not review permissive provisions of the lengthy document, relying instead on the caveat contained in Section 318(a) of the Act that any permissive provision contained in the Indenture would be invalid if it conflicted with the mandatory provisions listed on the Tie sheet. Those sections relied upon by the respondent and upon which the Court below based its decision, Sections 1405, 502 and 507, are permissive provisions which are not listed on the Tie sheet, and were not subject to review by the Commission's staff.

Understanding of the Securities Industry

The New York court's failure to consider the federal statute's mandatory requireemnts creates a dangerous precedent and forebodes substantial abuse. In addition to being diametrically opposed to the clear language of the Act and to the *Continental* case, the decision also failed

to consider the very purpose of the federal Act and the effect of its requirement in limiting subordination as set forth in Section 1405 of the Indenture.

It has long been accepted in the securities industry that subordination provisions in a convertible subordinated debenture become applicable only when, and if, a debtor is insolvent and seeks court protection under insolvency laws. This was made clear at lectures sponsored by the Practicing Law Institute by panels which included staff members of the Securities and Exchange Commission.

Panel and editorial discussions published by the Practicing Law Institute for the guidance of the securities bar, explain the meaning and purpose of convertible subordinated debentures as follows:

> "An increasingly common form of financing particularly for small companies is the so-called 'subordinated' debenture,* i.e., an unsecured debt obligation, the payment of which *in the event of bankruptcy or other insolvency proceedings* is specifically subordinated to specified 'senior debt', e.g., bank or institutional loans, trade debt, and the like." When Corporations Go Public, edited by Carlos E. Israels and George M. Duff, Jr. (1962) pp. 61-62. (Emphasis added).

Subordination provisions of a Debenture are not applicable where, as in the case at bar, the debtor is not engaged in insolvency proceedings. The decisions's failure to recognize this federal limitation on "subordination" may

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* Footnote omitted. Staff members of the Securities and Exchange Commission who participated on the panel were: Walter J. Costello, Division of Corporation Finance; Ralph C. Hocker, Assistant Director, Division of Corporation Finance; and Charles E. Shreve, Chief Counsel, Division of Corporation Finance.

well result in widespread abuse. It gives corporate debtors virtual carte blanche to withhold interest on debentures whenever they fall behind in payments on their current obligations or "senior debt", which is literally any debt *other* than the debentures (see pages 43-44 of the Record). Such a temptation for abuse should not be allowed to stand as the law of the land without careful review by the Supreme Court of the United States.

Summary

By virtue of the instant holding of the Supreme Court of the State of New York, any corporate debtor can withhold interest payments to debenture holders by merely citing a technical default in its senior debt (i.e., any unpaid bill). Debenture holders are prohibited from bringing an action against the corporate debtor because the debentures are "subordinated". The corporate debtor can borrow money based on an "unconditional promise" to pay interest and then impose its own moratorium on the payment of that interest.

The potential for abuse is obvious. The decision clearly circumvents the safeguards imposed by the federal statute. It is imperative that this Court decide these issues of first impression.

The issues herein have great importance to the securities industry and to the general public. A decision of such magnitude, which expands the boundaries of "subordination" beyond what the Securities and Exchange Commission's staff and the securities bar consider applicable, must be carefully weighed. Further, any holding giving a provision *allowed* by the Act, priority over a provision *required* by the Act warrants thorough review, analysis and discussion in light of Sections 316(b) and 318(a) of

the Act and *Continental Bank & Trust Co.* v. *First Nat. Petroleum Tr.*, supra, which require precisely the opposite result.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

GALPEER, ALTUS, KARP & BECKERMAN
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Of Counsel:

AARON KARP
HOWARD M. SOMMERS
JOEL SANKELL

March 10, 1980

APPENDIX

Appendix A

SUPREME COURT

NEW YORK COUNTY

SPECIAL TERM—PART I

Index No. 7757/78

IVEN S. YOUNG, ESTATE OF JACK YOUNG, ABRAHAM ALTUS, AARON KARP, IDA KARP, SHERMAN KARP, JOSEPH KARP, ABRAHAM SINGER,

Plaintiffs,

—against—

DISTINCTIVE DEVICES, INC.,

Defendant.

MEMO

RICCOBONO, *J.:*

This is a motion by the plaintiff pursuant to CPLR 3213 for an order granting summary judgment in lieu of complaint.

In December 1968 the plaintiffs purchased from the defendant an aggregate of $12,000 in principal amount of 6½% "Convertible Subordinated Debentures" due December 1, 1983. The debentures provide for semi-annual payments of interest on June 1 and December 1 of each year. The debentures were issued under an Indenture dated 1968 (copy annexed to defendant's answering affidavit).

It is agreed that the defendant failed to make interest payments for December 1, 1977 and June 1, 1978 (and will probably not pay further interest until 1980).

Appendix A

The plaintiffs contend that the defendant breached its obligation to them by reason of the defendant's default in the interest payments and therefore the plaintiffs demanded payment of the principal and interest.

It is clear from reading the debenture that it is not "an instrument for the payment of money only" within the ambit of CPLR 3213, since the debenture relies upon another document, to wit: the Indenture Trust Agreement, as to when the principal and interest are due in the situation at bar. However, it is also clear from the papers before the court that the parties have treated the motion on its merits and a further clarification through formal pleadings would be unnecessary. Therefore the Court will consider this motion pursuant to CPLR 3212.

There are no issues of fact before the court but rather only one of law. It is for the court to decide the application of the provisions of the debenture and the indenture agreement.

Contrary to the plaintiffs' contention, the court finds that section 1405 of the Indenture is applicable in the instant situation.

Section 1405 provides as follows:

"Section 1405. Default on Senior Debt.

"If there shall have occurred a default in the payment of the principal of (or premium, if any) or interest on any Senior Debt, then, unless and until such default shall have been cured or waived, no payment shall be made by the Company with respect to the principal (including Sinking Fund Payments) of (or premium, if any) or interest on the Debentures, except that Debentures acquired prior to such default may be delivered in lieu of a Sinking Fund Payment in cash in accordance with Section 1201."

Appendix A

The application of Section 1405 is not as plaintiffs argue dependent upon section 1402.

Whatever rights the plaintiffs have to sue or otherwise, pursuant to the indenture or other provisions of law do not detract from the applicability of section 1405 to the situation at bar.

In addition the court finds that both the language of the debenture and the indenture are clear and unequivocal in that the debentures are subordinate to the payment of the senior debt and the plaintiffs are not entitled to the relief sought herein. Furthermore, the restricted right of the plaintiffs to sue is clearly indicated by the name of the debenture, to wit: "Convertible Subordinated Debentures" and a further statement in the body of the debenture. Such notice is sufficient to restrict the debenture holders' right to sue. In addition, the plaintiffs have not met the requirements of section 502 of the Indenture to bring this action. (It is undisputed that there is a senior debt which is presently in default [see sections 1401 and 1405 of Indenture; also see reverse side of Debenture, left column, third paragraph]; also see *Kurtz* v. *American Export Industries,* 49 A D 2d 557, affd. 39 N Y 2d 738.)

Accordingly, the motion by the plaintiff is denied and summary judgment is granted to the defendant.

Settle order.

Dated: July 19, 1978.

J. S. C.

At a Special Term, Part I, of the Supreme Court of the State of New York, County of New York, held at the County Court House, New York County on the 18th day of September, 1978.

Present:

HON. XAVIER C. RICCOBONO,

Justice.

Index No. 7757/78

IVEN S. YOUNG, ESTATE OF JACK YOUNG, ABRAHAM ALTUS, AARON KARP, IDA KARP, SHERMAN KARP, JOSEPH KARP, ABRAHAM SINGER,

Plaintiffs,

—against—

DISTINCTIVE DEVICES, INC.,

Defendant.

ORDER

Upon plaintiffs' undated Notice of Motion for an order granting summary judgment in lieu of complaint pursuant to CPLR 3213 and upon the affidavit of Aaron Karp, sworn to April 18, 1978, and the exhibits annexed thereto, and upon the reply affidavit, supplemental reply affidavit and second supplemental reply affidavit of Aaron Karp, sworn to May 24, 1978, June 8, 1978 and June 9, 1978, respectively, and the exhibits annexed thereto, all submitted in support of the motion, and the affidavit of Earl M. Anderson, Jr., sworn to May 15, 1978, and the exhibits annexed thereto and the affirmation of Max Folkenflik, dated June 8, 1978, both submitted in opposition to the motion, and upon the

Appendix A

summons and all papers and proceedings heretofore had herein, and the Court having made its written memorandum decision dated July 19, 1978, it is ordered that:

1. The Plaintiffs' motion is denied, summary judgment is granted for defendant, and the action is dismissed with prejudice.

2. Defendant Distinctive Devices, Inc. shall recover costs and disbursements of this action, to be taxed by the Clerk of this Court.

3. The Clerk of this Court shall enter judgment in accordance with this order.

Enter,

X. C. R.
J. S. C.

Filed Sept. 30, 1978
New York Co. Clerk's Office

Appendix A

SUPREME COURT
OF THE STATE OF NEW YORK

COUNTY OF NEW YORK

Index No. 7757/78

IVEN S. YOUNG, ESTATE OF JACK YOUNG, ABRAHAM ALTUS, AARON KARP, IDA KARP, SHERMAN KARP, JOSEPH KARP, ABRAHAM SINGER,

Plaintiffs,

—against—

DISTINCTIVE DEVICES, INC.,

Defendant.

JUDGMENT DISMISSING ACTION

Plaintiffs having moved for an order granting summary judgment in lieu of complaint pursuant to CPLR 3213 and said motion having regularly come on to be heard on the 9th day of June, 1978 and it having appeared from the papers in support of and in opposition to the motion that defendant is entitled to a judgment as a matter of law, and the court having made its written memorandum decision dated July 19, 1978 and its order dated September 18, 1978 and the costs and disbursements having been duly taxed at the sum of Eighty ($80.00) Dollars,

Now, on motion of Kronish, Lieb, Shainswit, Weiner & Hellman, attorneys for defendant, it is

ADJUDGED, that the plaintiff's action be and same hereby is dismissed, and it is further

Appendix A

ADJUDGED, that defendant, Distinctive Devices, Inc., whose principal place of business is 2165 Fifth Avenue, Ronkonkoma, New York 11779, recover from Iven S. Young, the Estate of Jack Young, Abraham Altus, Aaron Karp, Ida Karp, Sherman Karp, Joseph Karp, Abraham Singer all of whose last known addresses are respectively: 245 East 35th Street, New York, New York 10016, 86-11 151st Avenue, Howard Beach, New York 11414, 110-42 69th Avenue, Forest Hills, New York 11375, 950 Third Avenue, New York, New York 10022, 1293 East 5th Street, Brooklyn, New York 11230, 2855 Sugarman Way, Lajolla, California 92037, 1215 Pericles Place, Whitehall, Pennsylvania 18052, 16812 127th Avenue, Jamaica, New York 11434, the costs and disbursements of this action as provided by statute taxed at $80.00 and that defendant shall have execution therefor.

Judgment signed this 5 day of October, 1978.

/s/ .....
Norman Goodman, Clerk

FILED
OCT 5 1978
New York
Co Clerks Office

Appendix B

At a term of the Appellate Division of the Supreme Court held in and for the First Judicial Department in the County of New York, on May 8, 1979.

Present:

HON. JOSEPH P. SULLIVAN,
Justice Presiding,

" MYLES J. LANE,
" ARTHUR MARKEWICH,
" SAMUEL J. SILVERMAN,
" DAVID ROSS,
Justices.

5343-44

IVEN S. YOUNG, ESTATE OF JACK YOUNG, ABRAHAM ALTUS, AARON KARP, IDA KARP, SHERMAN KARP, JOSEPH KARP and ABRAHAM SINGER,
Plaintiffs-Appellants,

—against—

DISTINCTIVE DEVICES, INC.,
Defendant-Respondent.

An appeal having been taken to this Court by the plaintiffs-appellants from an order of the Supreme Court, New York County (Riccobono, J.), entered on September 20, 1978 denying their motion for summary judgment in lieu of complaint and granting summary judgment dis-

missing the action, and from the judgment of said court entered thereon, on October 5, 1978, and said appeal having been argued by Mr. Aaron Karp, of counsel for the appellants, and by Mr. Edward M. Spiro, of counsel for the respondent; and due deliberation having been had thereon,

It is unanimously ordered that the order and judgment so appealed from be and the same are hereby affirmed. Respondent shall recover of appellants $75 costs and disbursements of this appeal.

ENTER:

JOSEPH J. LUCCI
Clerk.

Appendix B

At a term of the Appellate Division of the Supreme Court held in and for the First Judicial Department in the County of New York, on September 20, 1979.

Present:

HON. JOSEPH P. SULLIVAN,
Justice Presiding,

" MYLES J. LANE,
" ARTHUR MARKEWICH,
" SAMUEL J. SILVERMAN,
" DAVID ROSS,
Justices.

M-2480

IVEN S. YOUNG, ESTATE OF JACK YOUNG, ABRAHAM ALTUS, AARON KARP, IDA KARP, SHERMAN KARP, JOSEPH KARP and ABRAHAM SINGER,
Plaintiffs-Appellants,

—against—

DISTINCTIVE DEVICES, INC.,
Defendant-Respondent.

The above-named plaintiffs-appellants having moved for leave to appeal to the Court of Appeals from the order of this Court entered on May 8, 1979,

Now, upon reading and filing the notice of motion, with proof of due service thereof, and the papers filed in sup-

Appendix B

port of said motion, and the papers filed in opposition or in relation thereto; and due deliberation having been had thereon,

It is ordered that said motion be and the same hereby is denied with $20 costs.

ENTER:

JOSEPH J. LUCCI
Clerk.

Appendix C

STATE OF NEW YORK
COURT OF APPEALS

At a session of the Court, held at Court of Appeals Hall in the City of Albany on the thirteenth day of December A. D. 1979.

Present,

HON. LAWRENCE H. COOKE,
Chief Judge, presiding.

Mo. No. 1119

IVEN S. YOUNG, ET AL.,
Appellants,

vs.

DISTINCTIVE DEVICES, INC.,
Respondent.

A motion for leave to appeal to the Court of Appeals in the above cause having been heretofore made upon the part of the appellants herein and papers having been submitted thereon and due deliberation thereupon had, it is

ORDERED, that the said motion be and the same hereby is denied with twenty dollars costs and necessary reproduction disbursements.

/s/ JOSEPH W. BELLACOSA
Joseph W. Bellacosa
Clerk of the Court

79-1402

Supreme Court, U. S.
FILED
APR 11 1980
CLERK

IN THE

Supreme Court of the United States

IVEN S. YOUNG, ET AL.,

Petitioners,

-against-

DISTINCTIVE DEVICES, INC.,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR CERTIORARI

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1976

NO 79-1402

IVEN S. YOUNG, et al.,

Petitioners,

-against-

DISTINCTIVE DEVICES, INC.,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR CERTIORARI

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1. Question presented on this petition.

Whether, as Petitioners must contend, Section 316(b) of the Trust Indenture Act of 1939, 15 U.S.C. §77ppp ("Section 316(b)") outlaws subordination provisions.

2. Statement of the case.

(a) Summary.

The facts have never been disputed. A. 1, 2.* The law is clear. Point 3 infra. Petitioners bargained for and purchased subordinated debentures. The event of subordination has occurred. Section 316(b) does not prohibit such debentures. Nor does it excuse an event of subordination. Rather, the statute prohibits unconsented later changes in the payment rights prescribed in deben-

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* Citations preceded by the legend "A" are to the pages of the Appendix attached to the Petition for Certiorari.

ture instruments. It has no application to this case.

(b) The undisputed facts.

Petitioners bought $12,000 of the $4 million of the "6-1/2 Convertable Subordinated Debentures Due December 1, 1983" (the "Subordinated Debentures") issued by Respondent in December, 1968 R. 20, 23.*

The Subordinated Debenture flatly stated that: (1) the right to payment of principal and interest would be subordinate to the rights of senior debt as provided in the Indenture; and, (2) each holder accepted and agreed to

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* Citations preceded by the legend "R" are to the pages of the Record on Appeal presented to the Supreme Court of the State of New York, Appellate Division, First Department and placed before this Court by Petitioners.

that subordination by taking the Subordinated Debenture. R. 24.

In turn, the Indenture expressly subjected the debenture holders' rights to payment of principal and interest to the subordination provisions. Indenture Section 508, R. 70. The controlling subordination provisions prohibited payment of principal or interest on the Subordinated Debentures at any time during which defined senior debt should be in default. Indenture Section 1405, R. 122.

Interest on the Subordinated Debentures was timely paid from 1969 until December 1977. At that point, a senior debt default intervened. That default has continued. R. 26. No interest payments have been made since 1977. R. 26.

On April 28, 1978, the Indenture Trustee informed Petitioners and the other Subordinated Debenture holders that it appeared that the interest default would continue at least into 1980. The Trustee cautioned that a formal default declaration would be likely to cause insolvency proceedings in which the Subordinated Debenture holders would receive nothing. R. 139-40.

There has been no declaration of default under the terms of the Indenture and no acceleration of the principal obligation. Principal is not due until 1983. R. 23.

(c) Proceedings below.

The Petitioners immediately sued for the $12,000 principal amount of their debentures and for accrued

interest.* R. 18. That suit was dismissed as legally deficient by the Special Term of the New York Supreme Court. The debentures were clearly subordinate. The event of subordination had occurred and persisted. There had been no declaration of default under the Indenture. There was no right to interest payment until the senior debt default had been

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* Petitioners do not represent more than one percent (1%) of the outstanding debentures. R. 28. No demand has been made on the Trustee for a formal default declaration or for the institution of suit. The Indenture prohibits suit by holders unless instituted by the holders of at least twenty-five percent (25%) in value of the outstanding debentures at least sixty (60) days after the Trustee has been requested, but has failed, to sue. Indenture Section 507, R. 69-70.

The decisions below do not deal with this defect in plaintiffs suit except en passant in connection with the lack of any formal default declaration under Section 502 of the Indenture (R. 29.). A. 3.

These issues would obviously arise on a full hearing on the merits.

cured or waved. And, there was no right to sue for principal until a formal declaration of default and acceleration. A. 2-3.

The Appellate Division of the New York Supreme Court summarily affirmed. A. 8-9. The New York Court of Appeals refused to even hear the matter. A. 10-11.

(d) The present petition.

Petitioners now ask this Court to entertain this open and shut case. The proposed notion is that Section 316(b)'s prohibition against the impairment of, or adverse change in, a debenture holder's right to receive payment of principal or interest outlaws subordination provisions in the original debt instruments.* If Petitioners were

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* 15 §U.S.C. 77rrr provides that Section 316(b), inter alia, overrides inconsistent indenture provisions.

correct, all subordination provisions would be outlawed. By definition, all such provisions impair payment rights. However, Petitioners' legal analysis is wrong.

3. Section 316(b) does not prohibit subordinated debentures.

Section 316 does not forbid subordination provisions in original debt instruments. It only prohibits later unconsented changes which impair or adversely affect a debenture holder's right to receive the interest or principal due him at the time of the purported change in the terms of the debt. II Loss, Securities Regulation, 740 (2d ed 1961); Schallitz v. Starrett Corp., 82 N.Y.S.2d 89, 90 (Sup. Ct. 1948); Report of the Committee on Interstate and Foreign Commerce of the House of Representatives on the Trust Indenture Bill of 1939, H.R.

Rep. No. 1016, 76th Cong. 1st Sess. 36, 56 (1939) (the "House Report"). Accord, Continental Bank & T. Co. v. First Nat. Petroleum T., 67 F. Supp. 859 (D.R.I. 1946).

Petitioners have misread Section 316(b), its legislative history, and the Continental case. Their argument contradicts forty-one years' experience with subordinated debentures under the Trust Indenture Act of 1939.

First, Section 316(b) states that the payment rights prescribed by an indenture security cannot be impaired or adversely affected* without each debenture holder's consent. Nothing in the section even discusses subordination provisions. Section 316(b) does not say that an indenture security

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* With irrelevant exceptions.

may not qualify, restrict or condition the right to payment in the first instance. Nor does the statute forbid a debenture holder's agreement to subordination at the time of his purchase of a subordinated debenture. And, in any event, such a consent would satisfy the prohibition which only affects uncontested impairments. There is such a consent in this case. R 24.

Second, the legislative history offered by Petitioners contradicts their position and, in fact, demonstrates that Section 316(b) deals only with later changes in payment terms. The House Report states the purpose of Section 316(b) as the insurance of "judicial scrutiny of the fairness of debt-readjustment plans...." House Report, supra at p. 56, emphasis supplied. The draftsmen flatly stated that Section

316(b) deals with changes in indenture rights and waivers of existing defaults -- not with the original definition or limitation of those rights by subordination or other provisions:

> "This prohibition does not prevent the majority from binding dissenters by other changes in the indenture or by a waiver of other defaults, and the majority may of course consent to alterations of its own rights."

House Report, supra, at p. 56, emphasis supplied.

Third, the Continental case deals with a proposed "readjustment" of payment terms -- a moratorium on past due interest payments. The case has nothing to do with original indenture terms.*

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* Thus there is no conflict between the Continental case and the decision below. Missouri Pac. R. Co. v. Elmore & Stahl, 377 U.S. 134 (1964) can provide no jurisdictional base for this petition.

In Continental

> "the holders of a majority in principal amount of debentures at the time outstanding are attempting to force the postponement of interest payment for a period exceeding three years from its due date."
>
> * * *
>
> "[T]he action of holders of a majority in principal amount of debentures at the time outstanding in attempting to postpone and waive default of the interest payment is directly contrary to the provisions of the Act expressly prohibiting impairment of the right of a debenture holder to receive payment of interest...."

Continental Bank & T. Co. v. First Nat. Petroleum T., supra, 67 F. Supp. at 871. The Continental court held only that such a later change in the indenture provisions regarding interest payments violated Section 316(b). That is, Section 316(b) prohibited a majority of debenture holders from declaring an interest moratorium. The case has

nothing to do with original limitations expressed in debt instruments.*

Schallitz v. Starrett Corp., supra, is the only other published opinion which deals with Section 316(b). There, Justice Botein held that:

> "the statute forbids postponement only of interest actually due and payable by the terms of the indenture security ...."

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* Indeed, the Continental debentures had two original limitations on payment. Neither was challenged. The debentures were subordinated and they were "income" bonds. Payment of the eight percent (8%) interest was due only if, and to the extent that, there was sufficient "net income" to fund the payment. "Net Income" was defined as funds remaining after payment of operating and administrative expenses, certain taxes, and interest on senior debt. The Securities and Exchange Commission appeared as amicus curiae to aid in the construction of Section 316(b). No challenge was raised to either the subordination or the income limitations.

Schallitz v. Starrett Corp., supra, 82 N.Y.S.2d at 91, emphasis supplied.

Here, the debenture and the indenture both state, indeed advertise, that the right to payment is subordinate to, and conditioned on prior payment of, senior debt.* R. 24, 70, 122. That is,

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* Petitioners argue that a subordination provision cannot be invoked outside of an insolvency proceeding.

This is simply not so. There are two recognized types of subordination provisions: (1) the "inchoate" provision which is drawn in terms that delay its effect until voluntary or involuntary distribution of the debtor's assets; and, (2) the "complete" provision which prohibits payments as long as senior debt is unpaid. See, e.g., Calligar, Subordination Agreements, 70 Yale L. J. 376, 378 (1961); Coogan, Kripke & Weiss, The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements, 79 Harv. L. R. 229, 233-34 (1965); American Bar Foundation, Commentaries on Indentures, 575-76 (1971).

no interest or principal can be due or payable "by the terms of the indenture security" unless senior debt is current. There has been no change in these payment terms. The existing subordination provisions have merely been invoked.

Petitioners bargained for, bought and paid for their subordinated debt. They have received what they had bargained for. Their rights have not been changed. They have no case.

4. Conclusion.

The petition for certiorari should be denied. No substantial issue is presented. The Trust Indenture Act of 1939 did not outlaw subordination provisions. It cannot be tortured to do so. Petitioners bargained for and received a subordinated debenture. The implementation of the subordination

provisions did not impair or affect any right given them by the debt instruments.

Dated: New York, New York
March 10, 1980

Respectfully submitted,

SEYMOUR SHAINSWIT OF
KRONISH, LIEB, SHAINSWIT
WEINER & HELLMAN

Attorney for Respondent
Distinctive Devices, Inc.

Of Counsel:

Brian J. Gallagher